Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:LN:TL-N-4690-00
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date: September 29, 2000

to: Chief, Examination Division, Southern California District
Attn: [redacted]

from: District Counsel, Southern California District, Laguna Niguel

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subject: [redacted]--**Excise Tax on Foreign Insurance--Penalties Issue**

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

We previously issued an advisory memorandum to you dated August 21, 2000, regarding this issue. This memorandum supercedes that advice. Please discard all copies of the earlier memorandum.

ISSUE

Whether [redacted] ([redacted]) had reasonable cause for its failure to file Forms 720, reporting premiums paid to a foreign insurer, deposit the amounts due, and pay the tax due.

CONCLUSION

Yes, [redacted] did have reasonable cause for its failure to file, deposit, and pay with regard to the excise tax due on premiums paid to foreign insurers.

FACTS

[redacted] is a domestic corporation. [redacted] imports and distributes [redacted] manufactured by its parent corporation, [redacted] ([redacted]), which is located in [redacted]. [redacted] purchases the [redacted] from [redacted] under a "C.I.F." arrangement, which is governed by the provisions of the Uniform Commercial Code. A C.I.F. arrangement is one in which on each purchase invoice there is shown for every individual shipment (1) the cost of the articles, (2) the amount of the insurance premiums covering the shipment, and (3) the freight cost. Title to the articles and risk of subsequent damage or loss passes to [redacted] when the articles are placed on board a carrier in [redacted]. When the articles reach various United States ports, they are transported either by rail or truck to warehouses located throughout the United States for subsequent distribution. The insurance policies covering the [redacted] during shipment are obtained by [redacted] from foreign insurers.

The excise tax specialist on the audit team has proposed an adjustment, asserting that [redacted] is liable for the excise tax under I.R.C. § 4371 for the period [redacted], through [redacted]. The specialist has asserted that [redacted] owes the tax on the portion of the payments made by [redacted] to [redacted] that represent the separately stated insurance premium amount on the invoice. The specialist has also proposed assertion of the penalties for failure to file the required return, to make the required deposits of the tax, and to pay the tax.

[redacted] has stated that it does not believe that it is liable for the tax, but that it will agree to pay it in order to avoid the cost of litigating the issue. [redacted] has argued that the proposed penalties should not be asserted because the underlying doubt as to liability amounts to reasonable cause for its failure to file, deposit and pay. [redacted] argues that it is not actually liable for the tax because it did not make actual payments to the foreign insurer. It says this is required by Treas. Reg. § 46.4374-1(a), which states that

> such tax shall be remitted by the person who makes the payment of the premium to a foreign insurer or reinsurer or to any nonresident agent, solicitor or broker.

[redacted] argues that it does not meet the requirements of this regulation because it did not make payments to the foreign insurer. [redacted] argues that the payments made to [redacted] do not meet the requirements of the regulation because [redacted] is not a nonresident agent, solicitor or insurance broker.[1]

[redacted] also asserts that it should not be held liable for the penalties because the Service had examined its prior years without asserting that it was liable for this tax. Thus, it had no reason to believe, going into the years at issue, that its interpretation of the regulation was incorrect.

LAW AND ANALYSIS

The nature and purpose of the tax:

Section 4371 imposes a tax on each policy of insurance, indemnity bond, annuity contract or policy of reinsurance issued by any foreign insurer or reinsurer.[2] Pursuant to section 4371(1), the tax is imposed at a rate of four cents on each dollar, or fractional part thereof, of the premium paid on a policy of casualty insurance or indemnity bond, if issued to or for, or in the name of an insured as defined in section 4372(d).

Section 4372(d)(1) defines the term "insured" to include a domestic corporation or partnership, or an individual resident of the United States, insured against, or with respect to, hazards, risks, losses, or liabilities wholly or partly within the United States.

Section 4374 provides that the tax imposed by section 4371 shall be paid, on the basis of a return, by any person who makes, signs, issues or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued or sold.

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[1] There is no mention in the submitted materials of an agreement between [redacted] and [redacted] regarding which of the parties should bear the burden of the United States excise tax on foreign insurance policies. Such an agreement could be very important to the Government's case were the taxpayer not prepared to agree to pay the tax. In similar, future cases, it is suggested that an IDR be issued requesting copies of any such agreement or drafts of such an agreement.

[2] Section 4372(a) of the Code defines the term "foreign insurer" as an insurer who is a nonresident alien individual, a foreign partnership or foreign corporation.

Section 46.4374-1(b) provides that the liability for the tax imposed by section 4371 shall attach at the time the premium payment is transferred to the foreign insured or to any nonresident agent, solicitor or broker.

While the insurance premium excise tax originated in legislation enacted in 1918, the format of current section 4371 is the result of the Revenue Act of 1942, § 502, P.L. 77-753, which amended section 1804 of the 1939 Code, the predecessor of section 4371. The legislative history of the 1942 legislation indicates that, while the tax is a revenue raiser, it will "at the same time eliminate an unwarranted competitive advantage now favoring foreign insurers." H.R. Rep. No. 2333, 77th Cong., 1st Sess. 61 (1942). The purpose of the insurance excise tax was also explained, as follows, in United States v. Northumberland Ins. Co., Ltd., 521 F. Supp. 70 (D.N.J. 1981):

> [t]he competitive imbalance Congress sought to rectify stemmed from the fact that premiums paid to foreign insurance companies not engaged in a trade or business in the United States were not subject to any United States income tax, including withholding tax. [Citations omitted.]

See also The Neptune Mutual Assn., Ltd. of Bermuda v. United States, 13 Cl. Ct. 309, 87-2 USTC ¶ 16,461 (Cl. Ct. 1987), aff'd, vac'd and rem'd 862 F.2d 1546 (Fed. Cir. 1988) in which the Claims Court states that

> [b]efore the enactment of the predecessor statute to section 4371, foreign insurers who did not maintain a domestic agent could write casualty insurance on risks located in the United States without incurring federal tax liability. Conversely, domestic insurers and insurers having domestic agents were subject to federal income tax. This scheme of taxation was changed by the Revenue Act or 1918, which provided that nonresident foreign insurers who were not subject to income tax on their underwriting income, were liable for a three percent stamp tax ... . The purpose of the 1918 stamp tax ... was to equalize the tax burdens of domestic and foreign insurers. [Citations omitted.]

The nature of the arrangement between [redacted] and [redacted]

Section 2-320 of the Uniform Commercial Code contains the provisions set forth below regarding the terms C.I.F. and C. & F.:

(1) The term C.I.F. means that the price includes *in a*

lump sum the cost of the goods and the insurance and freight to the named destination. The term C. & F. or C.F. means that the price so includes cost and freight to the named destination.

(2) Unless otherwise agreed and even though used only in connection with the stated price and destination, the term C.I.F. destination or its equivalent requires the *seller at its own expense* and risk to:

(a) put the goods into the possession of a carrier at the port for shipment and obtain a negotiable bill or bills of lading covering the entire transportation to the named destination; and

(b) load the goods and obtain a receipt from the carrier (which may be contained in the bill of lading) showing that the freight has been paid or provided for; and

(c) *obtain a policy or certificate of insurance*, including any war risk insurance, of a kind and on terms then current at the port of shipment in the usual amount, in the currency of the contract, shown to cover the same goods covered by the bill of lading and providing for payment of loss to the order of the buyer or for the account of whom it may concern; but the seller may add to the price the amount of the premium for any such war risk insurance; and

(d) prepare an invoice of the goods and procure any other documents required to effect shipment or to comply with the contract; and

(e) forward and tender with commercial promptness all the documents in due form and with any indorsement necessary to perfect the buyer's rights.

(3) Unless otherwise agreed the term C. & F. or its equivalent has the same effect and imposes upon the seller the same obligations and risks as a C.I.F. term except the obligation as to insurance.

(4) Under the term C.I.F. or C. & F. unless otherwise agreed the buyer must make payment against tender of the required documents and the seller may not tender nor the buyer demand delivery of the goods in substitution for the documents. [Emphasis added.]

The contract between [redacted] and [redacted] is a C.I.F. contract, which is a

shipment contract with risk of subsequent loss or damage to the goods passing to [redacted] upon shipment with a common carrier if [redacted] has properly performed all its obligations with respect to the goods. Delivery to the carrier is delivery to [redacted] for purposes of risk and "title". One of the [redacted]'s obligations under the contract is to provide casualty insurance at its own expense.

Application of the statutory scheme:

a. [redacted] is an "insured" within the meaning of section 4372(d) and the policies are subject to the tax under section 4371(1)

Because the risk of loss passes to [redacted] when the goods are placed with a common carrier, and because the goods are insured until they reach [redacted]'s various warehouses in the United States, [redacted] qualifies as an "insured" within section 4372(d) of the Code. The insurance policy is issued for a domestic corporation with respect to risks partly within the United States. See Rev. Rul. 57-256, 1957-1 C.B. 416. Section 4371(1) imposes a tax, in part, on casualty insurance policies "*if issued* to or *for, or in the name of*, an insured as defined in section 4372(d)." The insurance policy therefore becomes subject to the excise tax under section 4371(1) of the Code by virtue of being issued for an insured.

b. alternative theories of liability

i. [redacted] as agent

Although [redacted] obtains the insurance policy from a foreign insurer, [redacted] does so for the benefit of [redacted] and passes the cost of the insurance on to [redacted] based on the terms of the C.I.F. shipping contract. When [redacted] pays [redacted] for the goods based on an invoice that includes the insurance cost, [redacted] is essentially reimbursing [redacted] for any premium payments [redacted] made to the foreign insurer for [redacted]'s benefit the same as a principal would reimburse an agent. Thus, [redacted] is a resident person making a premium payment to [redacted] acting in the capacity of a nonresident agent. Consequently, the requirements of section 46.4374-1(a) have been met. See G.C.M. 38684, I-345-80 (Apr. 10, 1981), modified by G.C.M. 39464, I-345-80, (Jan. 03, 1986) (holding that it is unnecessary to reach this question given the clear liability of a party in [redacted]'s position under section 4374).

ii. Section 46.4374-1(a) has been superceded by statute; payment by [redacted] to an agent is not required

Once it is determined that an insurance policy is subject to

the excise tax imposed under section 4371(1), section 4374 establishes liability for payment of the tax. Prior to its amendment in the Tax Reform Act of 1976, P.L. 94-455, § 1904(a)(12), section 4374 read as follows:

> Any person to or for whom or in whose name any policy... referred to in section 4371 is issued, or any solicitor or broker acting for or on behalf of such person in the procurement of any such instrument, shall affix the proper stamps to such instrument. Notwithstanding the preceding sentence, the Secretary or his delegate may, by regulations, provide that the tax imposed by section 4371 shall be paid on the basis of a return.

The last sentence in section 4374 above, authorizing the Secretary to change the stamp tax to a tax paid by a return, was enacted by P.L. 89-44, § 804(a) (June 21, 1965). The Secretary exercised the discretion to require that the tax be paid by return, instead of by stamp, in T.D. 7023 (January 21, 1970). This T.D. promulgated section 46.4374-1(a) of the Regulations, as follows:

> (a) *In general.* In the case of premiums paid on or after January 1, 1966, the tax imposed by section 4371 shall be paid on the basis of a return. Such tax shall be remitted by the person who makes the payment of the premium to a foreign insurer or reinsurer or to any nonresident agent, solicitor, or broker. For purposes of this paragraph, the person who makes payment means that resident person who actually transfers the money, check, or its equivalent to the foreign insurer or reinsurer (including transfers to any bank, trust fund, or similar recipient, designated by the foreign insurer or reinsurer), or to any nonresident agent, solicitor, or broker. (See section 4372(a) for definition of foreign insurer or reinsurer). For persons liable for the tax imposed by section 4371, see section 4384 and the regulations thereunder.

This regulation was intended to provide for payment of the tax by return as authorized under the old version of section 4374. The regulation explicitly provides that liability for the tax is to be determined under section 4384.

> Prior to repeal in 1976, section 4384 provided as follows:
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> The taxes imposed by this chapter *shall be paid by any person* who makes, signs, issues or sells any of the documents and instruments subject to the taxes imposed

> by this chapter, or *for whose use or benefit the same are made, signed, issued or sold.* ... [Emphasis added.][3]

In the Tax Reform Act of 1976, P.L. 94-455, § 1904(a)(12), Congress repealed section 4384 and amended section 4374 to its current reading, which requires payment of the tax by return rather than stamp and shifts the determination of liability for the tax, *without changing the test for liability*, from section 4384 to section 4374. See S. Rep. No. 94-938. 94th Cong., 2d Sess. 526 (June 10, 1986), 1976-3 C.B. Vol. 3, 526, which states the following:

> New Code section 4374 corresponds to present Code section 4384 except that it is changed to reflect payment by return rather than by stamp.

In other words, the change was simply meant to move the return provision from a legislative regulation to a statute.

Subsequent to its amendment in 1976, section 4374 provides that

> [t]he *tax imposed by this chapter shall be paid,* on the basis of a return, *by any person* who makes, signs, issues, or sells any of the documents and instruments subject to the tax, or *for whose use or benefit the same are made, signed, issued, or sold.* [Emphasis added.]

Thus, the duty to file the return, as well as liability for payment of the tax, now falls potentially on the insurer, the agent or the insured regardless of the form of payment and the manner in which the policy was procured.

Although section 46.4374-1(a) refers to the actual payment of the premium by the resident person to the foreign insurer, the regulation was published in 1970 prior to amendment of the statute in 1976. The regulation was meant to provide for payment by return. The amended statute now provides for this, rendering the regulation superfluous. Therefore, to the extent that section 46.4374-1(a) is inconsistent with section 4374, as amended, the regulation is no longer effective. See Enright v. Commissioner, 56 T.C. 1261 (1971).

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[3] Furthermore, according to G.C.M. 39464, the tax is payable by any of the parties to a taxable transaction and the parties to the transaction may agree among themselves as to which shall pay the tax.

Therefore, for purposes of section 4371 et seq., [redacted], as beneficiary of the insurance, is liable for the excise tax regardless of whether the payments it made to [redacted] were the type described in section 46.4371-1(a). Actual payment of premiums on a policy by [redacted] is not necessary to establish liability for the excise tax under section 4374 and the regulations thereunder, because the liability for the tax is on all makers, signers, issuers and beneficiaries of the insurance subject to tax under section 4371(1). See I.R.C. § 4374. Thus, [redacted] is liable for the section 4371 tax on the premiums paid for the insurance.

Penalties at issue:

An addition to tax is imposed under section 6651 for failure to file a return or pay the tax due within the prescribed period, unless it is shown that such failure was due to reasonable cause and not due to willful neglect. Section 6651(a)(1). The amount of the addition is 5 percent of the amount required to be shown as tax for each month that the delinquency persists, up to a maximum of 25 percent. An addition to tax is imposed under section 6656(a) for failure to make timely deposit of tax with a Government depositary, unless it is shown that such failure was due to reasonable cause and not due to willful neglect. For additions to tax assessed after October 21, 1986, the amount of the addition under section 6656(a) is 10 percent of the underpayment. Section 6656(a). For deposits required to be made after December 31, 1989, the addition is 10 percent of the underpayment in cases where the delinquency persists for 15 days or more. Section 6656(b)(1)(A)(iii).

Potential grounds for waiver of the penalties:

Generally, relief from penalties may be provided at the Examination level for one of four reasons: 1) reasonable cause; 2) statutory exceptions; 3) administrative waivers;[4] and 4) correction of Service error. At the Appeals' level, litigation hazards may also be taken into consideration. In the case at hand, [redacted] has proposed that it be relieved from liability only on the grounds of reasonable cause. It appears that no other potential ground is present.

For purposes of the penalties at issue, the delinquency is due to reasonable cause if the taxpayer exercised ordinary business care and prudence but was nevertheless unable to perform its tax obligations in a timely manner. Brewery v. United

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[4] Administrative waivers are generally formal, published waivers of penalties that are generally applicable to all similarly situated taxpayers. It is not applicable here.

States, 33 F.3d 589, 592 (6th Cir. 1994); In re Biomaterials Corp., 954 F.2d 919, 923 (3d Cir. 1992); Housden v. Commissioner, T.C. Memo. 1992-91; Proc. & Admin. Reg. § 301.6651-1(c)(1). The delinquency is due to willful neglect if it resulted from a conscious decision or from reckless indifference. United States v. Boyle, 469 U.S. 241, 245 (1985). The plain language of the proviso in both sections 6651(a)(1) and 6656(a) requires that reasonable cause and the absence of willful neglect be established as of the time that performance of the relevant obligation was due. See Industrial Indemnity v. Snyder, 54 AFTR 2d 84-5127, 84-1 USTC ¶ 9507 (E.D. Wash. 1984). Thus, whether the taxpayer acts in good faith and with ordinary business care and prudence in attempting to comply with its obligations after the deadline for performance has passed is of little or no direct relevance to the taxpayer's liability for the additions to tax under these sections. The burden of proving reasonable cause and the absence of willful neglect is on the taxpayer. Tax Court Rule 142(a).

In assessing ordinary business care and prudence, the IRS will examine the taxpayer's reason for failure to comply, whether the taxpayer has a history of complying with the tax law, the length of time between the event and the cited reason for the failure to comply, and whether the circumstances were beyond the taxpayer's control (Internal Revenue Manual (Handbook), [120.1] 1.3.1.2, August 20, 1998).

The penalties handbook provides a summary of some common situations that, depending on the surrounding facts and circumstances, may constitute reasonable cause. The grounds listed include:

(1) Ignorance of the law. Though taxpayers have an obligation to make reasonable efforts to determine their tax obligations (Internal Revenue Manual (Handbook), [120.1] 1.3.1.2.1, August 20, 1998);

(2) Mistake. Mistake is rarely in keeping with ordinary business care and prudence. However, it may be a supporting factor in certain circumstances (Internal Revenue Manual (Handbook), [120.1] 1.3.1.2.2, August 20, 1998).

(3) Forgetfulness. Forgetfulness is also rarely in keeping with ordinary business care and prudence (Internal Revenue Manual (Handbook), [120.1] 1.3.1.2.3, August 20, 1998).

(4) Death, serious illness or unavoidable absence (Internal Revenue Manual (Handbook), [120.1] 1.3.1.2.4,

August 20, 1998).

(5) Inability to obtain records (Internal Revenue Manual (Handbook), [120.1] 1.3.1.2.5, August 20, 1998).

[redacted] is not arguing that the penalties should be waived for any of these reasons. It is arguing that it does not owe the tax and is agreeing simply to avoid further expense. From the Service's standpoint, this argument is simply a version of the ignorance of the law argument--except that the taxpayer refuses to admit to the ignorance.

We do not concur in the taxpayer's view that there is an ambiguity in the regulations that justifies the taxpayer not depositing and paying the excise tax and not filing excise tax returns. [redacted] While the excise tax issue was not identified in the prior audits, this situation is not unlike the one in Miles v. Commissioner, T.C. Memo. 1997-207, where the Tax Court concluded there was reasonable cause for the taxpayer to claim a deduction that had not been disallowed in a prior audit. [redacted]

CONCLUSION

Although [redacted]'s liability for the tax is clear, the failure to file, deposit and pay is based on reasonable cause.

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